

22 February 2011

Ms. Louise L. Roseman  
Director  
Division of Reserve Bank Operations and Payment Systems  
Board of Governors of the Federal Reserve System  
Washington, DC 20551

Re: **Comments on the Notice of Proposed Rule Making on Debit Card Interchange Fees and Routing, Docket No. R-1404**

Dear Ms. Roseman,

On behalf of U.S. PIRG please find our comments on the Notice of Proposed Rule Making on Debit Card Interchange Fees and Routing, Docket No. R-1404 (“proposed rule”). U.S. PIRG serves as the non-profit, non-partisan Federation of State Public Interest Research Groups, which are public interest advocacy groups with over one-half million members nationwide. On behalf of our members and other consumers, U.S. PIRG has testified in the past three Congressional sessions in favor of swipe fee reform.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included the Durbin Amendment on debit interchange fees and practices. We believe the Durbin Amendment, along with the implementation of the proposed rule, will have a beneficial impact on consumers and merchants by reining in excessive debit fees and eliminating or preventing anticompetitive practices of some payment card networks.

Below we provide comments on the following topic areas:

- **The swipe fee market is broken and all consumers pay more for less because of escalating swipe fees.** The Board’s proposed rule is a step in the right direction to help correct the current market.
- **Comments on three specific portions of the proposed rule:**
  - **Reasonable and Proportional Interchange Transaction Fees.** Alternative 1, allowing for a safe harbor of 7 cents and a cap of 12 cents in the better proposed alternative.
  - **Fraud Prevention Adjustment.** U.S. PIRG recommends that to the extent the Board does provide for a fraud prevention adjustment allowance to issuers, such allowance ought to strongly encourage a shift to safer, lower-cost less fraud-prone PIN-based systems.
  - **Network Exclusivity and Routing.** Alternative B, allowing for at least two unaffiliated networks available for processing a transaction is the better alternative. Alternative B provides for greater merchant routing options. Giving merchants the ability to route is critical to spurring network competition, which will lead to lower prices and increased benefits for consumers.

- **There is little to no evidence that the proposed rule will lead to an increase in consumer fees.** Subsequent to publication of the proposed rule, a number of covered, as well as exempt, financial institutions have stated the rule will have negative implications on consumers, mainly in the increase of deposit account related fees. We believe such concerns are overstated. There is no demonstrated relationship between debit card swipe fees and other consumer charges.

We are pleased to offer the below comments to the proposed rule.

**I. The current swipe fee market is broken and all consumers pay more for less because of escalating swipe fees.**

The main driver behind the Durbin Amendment was an effort to regulate the broken payment card market which allowed debit card interchange fees to escalate fourfold to more than \$16 billion a year. U.S. PIRG has significant concerns about the problem of escalating debit card interchange fees. Debit interchange fees directly cost merchants and consumers an average of \$16.2 billion each year. These fees have a disproportionately harmful effect on the 25% of the population that is unbanked and other consumers that pay by cash and checks, since those consumers never receive the benefits of any credit or debit rewards programs that are funded by interchange fees. Moreover, card and cash paying consumers alike pay interchange fees, but cash paying consumers are burdened with higher prices without realizing any credit or debit program rewards.

Over time, interchange fees have evolved to compensate the card-issuers for costs such as insurance, fraud, risk of loss, float and processing (much of which is not even applicable to debit cards). Yet, while all these costs have decreased in the past 15 years, interchange fees have continued to increase (over 20% in the past few years, even though all the costs of card processing and issuance have fallen). Debit card fees on Interlink increased over 30% just this past year alone. The divergence between lower costs and higher fees has grown to the point where card networks no longer even attempt to justify interchange as a method for recovery of the cost of processing transactions.

Equally as problematic, the current debit card swipe fee system provides perverse incentives for financial institutions to issue more fraud prone signature-based debit cards. Signature based cards are far less safe from fraud since they do not require the use of a personal identification number ("PIN") and the debit from the account is not instantaneous. Not surprisingly signature-based debit cards have seven and a half times the rate of fraud as PIN-based cards. Yet because the networks and issuers of signature-based debit cards are able to exercise their market power, they have levied higher interchange fees. Banks use a variety of tactics to force consumers to use these cards either by providing rewards, or assessing surcharges on PIN debit transactions, or both.

Additionally troubling to lower-income consumers is that recent studies have demonstrated swipe fees to be a regressive penalty on the unbanked and underbanked. Some modest portion of swipe fees may benefit a small segment of consumers through rewards programs. (Only a small portion of debit cards have rewards programs). Yet while unbanked Americans receive no benefit from these programs, they pay in excess of \$1 billion annually to subsidize those regressive rewards.<sup>1</sup> The Federal Reserve Bank of Boston has found that each credit-card using household receives a cross-subsidy of \$1,133 from cash users every year.<sup>2</sup> The Hispanic Institute has reported that the bottom 50 percent of

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<sup>1</sup> Testimony of Edmund Mierzwinski, US PIRG, before the Subcommittee on Financial Services and General Government of the U.S. Senate Appropriations Committee, Hearing on Interchange Fees (June 16, 2010).

<sup>2</sup> Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses From Credit Card Payments? Theory and Collaborations*, Federal Reserve Bank of Boston Public Policy Discussion Paper No. 10-3, August 2010.

income earners pay at least \$669 million more in higher prices to subsidize at least \$354 million in payment card rewards.<sup>3</sup>

A system that promotes escalating fees resulting in higher priced goods, as well as the less secure and more costly payment card product for consumers makes no economic sense and is a sign of a broken market.

## II. Comments to the Proposed Rule

As requested by the Board, we provide specific comments below on the following portions of the proposed rule:

- **Reasonable and Proportional Interchange Transaction Fees;**
- **Fraud Prevention Adjustment; and**
- **Network Exclusivity and Routing.**

### a. Reasonable and Proportional Interchange Transaction Fees

The Board's proposed rule provides two alternative standards for determining whether the amount of an interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.<sup>4</sup> Alternative 1 allows an issuer to set its own internal maximum amount of interchange that it may receive by calculating its average variable costs for authorization, clearance and settlement of debit transactions. This alternative provides for a safe harbor amount of 7 cents, and a cap at 12 cents per transaction. Alternative 2 allows issuers to recover no more than 12 cents per transaction. Of the two alternatives, U.S. PIRG favors Alternative 1.

Prior to issuing the proposed rule the Fed conducted surveys of the issuers and payment card networks to determine their real costs of electronic payment processing. Based on the survey results, the Fed determined the average costs for issuers to be 4 cents. Expert reports submitted to the Board by the Merchants Payments Coalition found even lower costs for processing electronic payments: \$0.0033 for PIN debit transactions, and \$0.0136 for signature debit transactions.<sup>5</sup> Alternative 1 provides for an interchange amount of 7 to 12 cents per transaction, which is a 75 to 300 percent margin above actual cost. This amount leaves plenty of room for issuers to cover extraneous costs they claim are necessary beyond the authorization, clearance and settlement of an electronic payment.

The Board has requested comment on whether it should allow recovery through interchange fees of other costs of a particular transaction beyond authorization, clearance and settlement costs, as well as comment on whether it should limit allowable costs to include on the costs of authorizing a debit card transaction.<sup>6</sup> Because the Durbin Amendment has required the Board in its analysis to consider the

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<sup>3</sup> The Hispanic Institute, *Trickle-Up Wealth Transfer: Cross-Subsidization of Consumers in the Payment Card Market*, November 2009.

<sup>4</sup> "Debit Card Interchange Fees and Routing; Notice of proposed rulemaking," 75 Fed. Register 248, at 81726 (December 28, 2010).

<sup>5</sup> Stephen C. Mott, *Industry Facts Concerning Debit Card Regulation Under 920*, Submitted on behalf of the Merchants Payments Coalition to the Board of Governors of the Federal Reserve System Concerning Its Rulemaking Pursuant to Section 920 of the Electronic Fund Transfer Act, at ¶ 35 (October 29, 2010).

<sup>6</sup> Inclusion of extraneous costs was considered in the Board's cost measurement analysis. The Board however concluded that fixed costs and other costs such as overhead costs, account set-up costs, network fees, cardholder rewards, customers service costs, or other costs of deposit accounts not attributable to debit card transaction, which would still be incurred in the absence

functional similarities between debit and paper checks, which clear at par, we believe that there is a strong argument that the Board should limit the allowable costs to include only the costs of authorizing a debit card transaction. After all, a **debit card is simply an electronic check**. As the Board recognizes in the proposed rule, “for checks there is nothing analogous to an interchange fee to reimburse the issuer for the cost of clearing and settling a transaction.”<sup>7</sup> Moreover, the Federal Reserve has prohibited the equivalent of swipe fees on paper checks for nearly one hundred years. That has made the U.S. check system more efficient and ensured that the fees that are charged are transparent and competitive. There is simply no economic basis for swipe fees for electronic checks.<sup>8</sup>

Nevertheless, U.S. PIRG does recognize that the Durbin Amendment specifically requires the Fed to consider the incremental costs of authorization, clearance and settlement when considering the processing costs of an electronic debit transaction. The Board should limit allowable costs to no more than authorization, clearance and settlement for a debit card transaction. Even the Board has recognized that “issuers have other sources, besides interchange fees, from which they can recover revenue to help cover the costs of debit card operations.”<sup>9</sup>

#### **b. Fraud Prevention Adjustment**

The Durbin Amendment expressly authorizes the Board to make fraud adjustment allowances to issuers’ interchange fee levels. Specifically, the Amendment requires that the adjustment be reasonably necessary to make allowances for costs incurred by the issuer in preventing debit card fraud; and it requires issuers to take effective steps to reduce the occurrence of, and costs from development and implementation of cost-effective fraud prevention technology.<sup>10</sup> The Board does not specifically propose a specific method for fraud adjustment; instead it requests comments on “how to implement an adjustment to interchange fees for fraud-prevention costs.”<sup>11</sup>

The debit interchange system that exists now is one built on an anticompetitive market with perverse fraud prevention incentives. The networks provide much greater incentives for financial institutions to issue more fraud-prone signature debit cards over the safer and more efficient PIN debit. Signature based cards are far less safe from fraud since they do not require the use of a personal identification number and the debit from the account is not instantaneous. Signature-based debit cards have seven and a half times the rate of fraud as PIN-based cards.<sup>12</sup> Yet because the networks and issuers of signature-based debit cards are able to exercise their market power, merchants are required to pay higher interchange fees when their customers use less secure signature-based debit cards and this leads to higher prices for consumers. We believe that banks should not be rewarded through higher interchange fees through continuing to promote the inefficient and more fraud prone signature debit cards.

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of debit card transactions, were not appropriate to include in the allowable costs to be recovered by issuers under the Durbin Amendment.

<sup>7</sup> 75 Federal Register 248, at 81735.

<sup>8</sup> There is a strong case to be made that the most effective solution to the broken swipe fee market problem would be to set interchange at par as other countries have done. An at-par interchange system would benefit consumers as a whole by reducing overall retail prices, increasing issuer competition and incentivizing safer, less fraud-prone PIN debit use.

<sup>9</sup> 75 Federal Register 248, at 81736.

<sup>10</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 1075 (a)(2).

<sup>11</sup> 75 Fed. Register 248, at 81742.

<sup>12</sup> 75 Federal Register 248, at 81740-41 (of the \$1.36 billion in debit card fraud losses, \$1.15 billion arose from signature debit card transactions, and \$200 million arose from PIN debit card transactions).

The proposed rule specifically asks “Should the Board consider adopting an adjustment for fraud-prevention costs for only PIN-based debit card transactions, but not signature-based debit card transactions, at least for an initial adjustment, particularly given the lower incidence of fraud and lower chargeback rate for PIN-debit transactions?”<sup>13</sup> **U.S. PIRG believes that any fraud-adjustment scheme should strongly encourage a rapid shift in issuers’ incentives to provide consumers with more PIN-debit over fraud-prone signature-based cards.**

### c. Network Exclusivity and Routing

The Durbin Amendment requires the Board to adopt regulations that curb restraints on those who accept debit cards for payment that currently exist under “network exclusivity.” Also, the Durbin Amendment obliges the Board to provide rules that prohibit “an issuer or payment card network [from]...inhibit[ing] the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions.”<sup>14</sup> Such rules imposed by the networks include MasterCard’s imposition of a fee to merchants if a transaction could have been routed over the MasterCard network but was cleared on another network; and Visa’s rules requiring that MasterCard’s signature debit network not be offered on the same card as Visa’s signature debit network.<sup>15</sup> These rules prohibit merchants from choosing a lower-cost network that may be available, which is crippling to competition.

The Board has requested comment on the two proposed alternatives, and the effect of each alternative on cardholders.<sup>16</sup> Alternative A would allow debit cards to be enabled to be processed over at least two different unaffiliated networks regardless of authorization method, meaning one signature and one PIN network. Alternative B would allow for debit cards to have at least two unaffiliated networks available for processing a transaction for each method of authorization available to the cardholder, or two signature and two PIN networks. Alternative B provides for merchant-controlled routing and is therefore the better alternative from the consumer perspective.

Merchant routing is pro-consumer. Giving merchants the ability to route is critical to spurring network competition, which in turn will lead to lower consumer prices. Alternative B provides the greatest choice for merchant routing options. Alternative B allows for multiple signature and PIN debit card network choices on each card allowing merchants to better control the routing. This will reduce networks’ exercise of market power over merchants and incentivize them to compete by offering lower fees and better quality and services, which in turn benefits consumers.

The proposed rules note some potential drawbacks to Alternative B from the cardholder perspective. Specifically, they state that this alternative could limit cardholders’ ability to obtain certain card benefits, and limit the networks’ ability to provide certain protections regarding fraudulent activity, including liability protections and chargeback rights.<sup>17</sup> We believe that these concerns are overstated, and any adverse effect would be minimal. Any rewards programs on debit cards are very modest and are enjoyed by very few consumers. The protections illustrated in the rule and efforts to control fraud are typically directed by the card issuer and not the network, and those efforts will not be deterred by the network that is selected. The issuers will receive the same information and be able to detect fraud no

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<sup>13</sup> 75 Fed. Register 248, at 81742.

<sup>14</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 1075 (a)(2).

<sup>15</sup> See Visa International Operative Regulations, April 1, 2010, ID#: 0140410-010410-0006300.

<sup>16</sup> 75 Fed. Register 248, at 81750.

<sup>17</sup> 75 Fed. Register 248, at 81748-49.

matter which network handles the transaction.<sup>18</sup> We do not concur that Alternative B would adversely impact consumers.

Through merchant-directed routing, networks and issuers will have the incentive to compete on lower fees and better services, which directly benefits consumers. Overall, providing greater network routing through merchant choice will facilitate greater use of the PIN debit networks as well as entry and expansion of other signature debit networks, which can reduce the market power of Visa and MasterCard. Greater competition will lead to significant consumer benefits.<sup>19</sup>

### **III. There is little to no evidence that the proposed rule will lead to an increase in consumer fees.**

Since the issuance of the Board's proposed rules, there has been a bombardment of comments to the Board and statements in the media on the negative impact regulation will have on consumers. The main criticism seems to be that the reductions in debit card swipe fees proposed in the Fed's rule will force banks to increase other fees on demand deposit accounts. The facts simply do not support this argument.

First, there is simply no demonstrated relationship between debit card swipe fees and other consumer charges. Although debit card swipe fees increased almost four-fold over the past decade, there was no related decrease in other charges to consumers -- in fact, consumer costs have been going up consistently for 10 years.<sup>20</sup> For example, overdraft fees hit a record \$38 billion in 2009, which was double what they were in 2000.<sup>21</sup> Simply, swipe fees have been another source of income for the banks.

Some banks have raised the specter that free checking would be lost if the proposed rule is implemented and swipe fees declined. First, for many consumers, free checking was a front-end come-on for punitive back-end overdraft fees (which have since been strictly regulated by the Board due to abuses). But "free" checking existed as far back as the 1980s, when some cards carried negative swipe fees or had swipe fees far lower and even less than the level of the proposed, regulated fees. Moreover, there is significant free checking in Canada even with a zero swipe fee rate. Simply, the relationship between swipe fees and free checking is dubious.

Second, even when regulated at the amounts proposed in the rule, debit cards will be profitable. Prior to issuing the proposed rule the Fed conducted surveys of the issuers to determine their real costs of electronic payment processing. Based on the survey results, the Fed determined the average costs for issuers to be 4 cents, yet the proposed rule allows for swipe fees higher than 4 cents; it allows for 7 to 12 cents per transaction. **Moreover, the proposed rule merely reduces the swipe fee to approximately the level it was about a decade ago. Since then debit card costs to issuers have fallen. If the cards were profitable at that rate ten years ago they should be profitable today.**

Third, banks admit that swipe fees are just one of many revenue streams that banks get on checking accounts. It is not necessary for banks to cover every cost they have for their entire business through swipe fees any more than grocery stores have to cover every cost they have for their entire

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<sup>18</sup> After a review of the largest regional PIN-debit networks, we have not found any assertions by these networks of better protections offered over those of card issuers.

<sup>19</sup> Such consumer welfare is certainly the focus of the Dodd-Frank Act amendments to the Electronic Fund Transfer Act, under which Section 904 it states "[t]he primary objective of this title...is the provision of individual consumer rights."

<sup>20</sup> Kathy Chu, "Rising Bank Fees are Setting Records," USA Today (October 27, 2008).

<sup>21</sup> Saskia Scholtes and Francesco Guerra, "Banks Make 38bn from Overdraft Fees," Financial Times (August 9, 2009).

business through selling milk. Moreover, the proposed rules recognize that banks have other profit centers besides swipe fees: “[T]he Board also recognizes that issuers have other sources, besides interchange fees, from which they can receive revenue to help cover the costs of debit card operations.”<sup>22</sup>

Finally, this argument about increased consumer charges is a line consumers have heard many times before. Nearly 100 years ago banks said the same thing about the death of checks if the Board eliminated the system of exchange fees. Checks did not disappear, but rather their use grew very rapidly. They, like debit cards, are important tools to promote the demand deposit account, which is very valuable to banks. Banks will compete over these charges as they compete over other aspects of the demand deposit account. That is a far greater amount of competition than in the swipe fee market. The bottom line is that banks would move consumer fees up as much as they can to maximize profits based on market conditions even if this rule disappeared tomorrow. The proof of that is the fact that swipe fees on merchants have tripled just since 2001 while the banks have continued to raise consumer fees too.

**a. Reductions in swipe fees should result in substantially lower prices for all consumers.**

The other major claim by opponents to the proposed rule is that merchants will not pass any savings realized from reduced interchange on to consumers. This claim is inconsistent with both sound economic policy and recent history in other countries. The reduction in debit swipe fees will result in substantial benefits to all consumers, including the 25% of Americans who are unbanked.

First, economic theory teaches that in competitive markets, lower costs will lead to lower prices to consumers. The staff of the Fed has a clear understating of this as echoed in their presentation of the proposed rule stating that “given reductions in interchange fees and in overall debit card acceptance cost, merchants could choose to pass the savings through which could benefit both the consumers that primarily pay with cash or checks, as well as debit card users. We expect this would be most likely to happen, that is, lower costs would be most likely passed on to consumers, in those markets with lower margins and intense price competition.”<sup>23</sup>

Second, in Australia, the Reserve Bank found in 2005 that “the most notable impact of the reforms [on credit card swipe fees] has been a marked reduction in merchants’ costs of accepting credit cards, which in turn, is flowing through into lower prices of goods and services for all consumers.”<sup>24</sup> Moreover, in 2008, the Reserve Bank reported that reduced swipe fees resulted in lower prices and the fact that merchants passed savings from lower swipe fees on to the consumer “is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge.”<sup>25</sup> And in its 2007/2008 review, the Reserve Bank found consumer savings of \$1.1 billion Australian in one year.<sup>26</sup>

Further, in conjunction with the University of Pennsylvania, in 2009 the Hispanic Institute studied the impact of anticompetitive swipe fees on consumers. The study found that “lower interchange

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<sup>22</sup> 75 Fed. Register 248, at 81736.

<sup>23</sup> Federal Reserve Open Board Meeting, December 16, 2010.

<sup>24</sup> Payments Systems Board Annual Report, *Reserve Banks of Australia*, 2005 at 10.

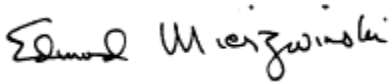
<sup>25</sup> Reform of Australia’s Payments System Preliminary Conclusions of the 2007/08 Review (April 2008).

<sup>26</sup> *Id.* It should be noted that proponents of swipe fees often site a MasterCard funded study, which found no benefit to consumers from the reduction of swipe fees in Australia. However, the Reserve Bank of Australia vigorously disputes this study’s findings.

fees result in lower prices for consumers and higher interchange fees result in higher prices for consumers.”<sup>27</sup> Moreover, a recent EU enforcement action found that “there is no economic evidence” to support the claim that reduced swipe fees would lead to higher charges to consumers. After carefully examining the claims of the card networks, the EU concluded that debit cards would be profitable even absent a swipe fee and there was little evidence that higher swipe fees had led to lower cardholder fees. “The evidence gathered during the inquiry rather suggests that the pass-through of higher interchange fees to lower cardholder fees is small.”<sup>28</sup> The EU concluded that: “Consumers already pay the cost of the interchange fee without knowing it. This cost is now hidden in the final retail price and is therefore non-transparent. Our objective is to improve transparency, so that consumers know how much and when they are paying for a card.”<sup>29</sup>

We thank you for your time and efforts spend on preparing the proposed rule. Please let us know if we can provide any further information as the Board considers finalizing the proposed rules.

Sincerely,

A handwritten signature in black ink that reads "Edmund Mierzwinski". The signature is written in a cursive, slightly slanted style.

Edmund Mierzwinski  
Consumer Program Director  
U.S. PIRG  
[edm@pirg.org](mailto:edm@pirg.org)

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<sup>27</sup> The Hispanic Institute, *Trickle-Up Wealth Transfer: Cross-Subsidization of Consumers in the Payment Card Market*, November 2009.

<sup>28</sup> EU Competition Commission, *Competition: Final Report on Retail Banking Inquiry - Frequently Asked Questions* (January 31, 2007).

<sup>29</sup> *Id.*